

Kentucky Tax Alert

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NOTE: This 2006 legislative summary presents only general information concerning the major tax provisions the General Assembly has enacted and does not represent a complete analysis or specific interpretations of the law changes. The Department of Revenue (DOR) will provide more specific information as it implements these changes. Full text of enacted bills is available on the legislative home page at www.lrc.ky.gov.

The 2006 Kentucky General Assembly created, amended or repealed numerous statutes. A total of 1,012 bills and 666 resolutions were introduced. In the end, 223 bills became law, an enactment rate of 22 percent. Nine bills had substantive tax implications, with some affecting more than one tax. This review describes the tax portion of each bill impacting taxes or programs administered by the DOR.

ADMINISTRATIVE

Comprehensive Tax System (Effective April 25, 2006)—The Executive Branch budget allocates \$23,250,000 for the DOR to acquire a new Comprehensive Tax System to replace the existing system. This funding will enable the department to focus on new, comprehensive, information-technology systems that may utilize current Web-based technologies and have the ability to blend with other technologies of the future. **(HB 380)**

Enhanced Revenue Collections (Effective April 25, 2006)—Allocates \$8.5 million in FY06-07 and \$8.9 million in FY07-08 to fund and support 139 new employees in the DOR. **(HB 380)**

License and Bond Revocation Hearings (Effective July 12, 2006)—Amends KRS 13B.020(3)(a) to exempt license and bond revocation hearings for motor fuels dealers, liquefied petroleum gas dealers and cigarette licensees conducted by the DOR from administrative hearing requirements of KRS Chapter 13B. KRS 138.195(9), 138.340(1) and 234.350(5) require that the department provide licensees with notice, a hearing and an opportunity to present evidence regarding the revocation of the license. Each provides that subsequent to the DOR conducted hearing, the licensee may appeal the department's decision to revoke a license to the

Kentucky Board of Tax Appeals, which conducts KRS Chapter 13B hearings. **(HB 557)**

Recording of Taxpayer Conferences (Effective July 12, 2006)—KRS 131.081 was amended to provide that the DOR may make a recording of any conference or hearing without prior notification, if the taxpayer seeks to record the conference or hearing. **(HB 557)**

Administrative Offsets for Delinquent Taxes and Liquidated Debts (Effective April 25, 2006)—Under existing law, the commonwealth entered into a reciprocal agreement with the federal government to allow each to collect liquidated tax debts for the other. This means that if a taxpayer is entitled to a federal refund but is delinquent in Kentucky taxes, then the federal government can capture that refund and send it to the commonwealth. This language expands the authority for reciprocal agreements to offset liquidated debts to the commonwealth to include nontax claims against the federal government and claims against other states. It will also allow city and urban county governments to participate in the state's vendor and tax refund offset programs. **(HB 380)**

Electronic Levies for Delinquent Tax Collections (Effective April 25, 2006)—Under existing law KRS 131.500 et seq., the DOR may issue levies against the bank accounts of delinquent taxpayers after all other means have been exhausted. This provision creates a new section in KRS Chapter 131 to augment the paper levy process now in place by providing for the use, once every calendar quarter, of an electronic medium to effectuate a data match and levy against every financial institution in Kentucky, including banks, credit unions,

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brokerage firms and insurance companies, for the collection of delinquent taxes, delinquent support for children and certified debts owed the commonwealth. **(HB 380)**

Alternative Path to Refund Repealed (Effective July 12, 2006)—Repeals the redundant refund provision of KRS 138.500. This provision is unnecessary because KRS 134.580 applies to refund situations for the taxes involved (cigarettes, other tobacco products and snuff, state gasoline and special fuel tax and motor vehicle usage tax). **(HB 557)**

ALCOHOLIC BEVERAGE TAX

Small Wineries (Effective Jan. 1, 2007)—Creates a new classification of wine wholesaler (small farm winery wholesaler), which essentially merges small and farm wineries into small farm wineries. Extends wholesale sales tax exemption to all wine produced by a small farm winery. **(SB 82)**

CORPORATION AND INDIVIDUAL INCOME TAX

Alternative Minimum Calculation Relief (Effective for taxable years beginning on or after Jan. 1, 2007)—The Executive Branch budget bill as proposed by Gov. Fletcher and modified and enacted by the General Assembly contained relief for small businesses from the alternative minimum calculation (AMC) of the corporate income tax.

Under the revised calculation, businesses with total gross receipts of less than \$2 million are exempt from the AMC and would therefore pay the higher of the corporate income tax as calculated using the rate schedule or a \$175 minimum tax.

Businesses with total gross receipts of more than \$2 million but less than \$10 million would receive relief based on the following formula:

$$(.00095 * KY GR) - (1,900 * (10,000,000 - KY GR) / (8,000,000))$$

Businesses with total gross receipts equal to or greater than \$10 million will continue to pay tax on the greater of:

- the corporate income tax as calculated using the rate schedule;
- the lesser of the gross receipts or gross profits calculations for AMC; or
- \$175 minimum tax.

The AMC as originally enacted in 2005 established an AMC for corporations, based upon either 0.095 percent of Kentucky gross receipts or 0.75 percent of Kentucky gross profits, whichever is less, and would remain unchanged for businesses with total gross receipts in excess of \$10 million. **(HB 380)**

Exclusion for Soldiers Killed in Line of Duty (Effective retroactively for tax years beginning after Dec. 31, 2001)—Excludes *all income from all sources* for active duty and reserve members and officers of the Armed Forces of the U.S. or National Guard who are killed in the line of duty, for the year during which the death occurred and the year prior to the year during which the death occurred. *All income from all sources* includes all federal and state death benefits payable to the estate or any beneficiaries. **(HB 380)**

Disregarded Entity Clarification (Effective July 12, 2006)—Clarifies that the owner of a disregarded entity for federal income tax purposes shall be considered to have nexus in Kentucky for Kentucky income tax purposes. **(HB 557)**

HB 403 corrected drafting errors in the Tax Modernization bill (HB 272) enacted in the 2005 session and clarified implementation issues that were unforeseen at the time of the bill's passage. Following are technical corrections to HB 272:

Priority and Use of Tax Credits (Effective retroactively for taxable years beginning on or after Jan. 1, 2005)—Corrects a subsection reference number to KRS 141.0205 relating to the priority and use of tax credits. **(HB 403)**

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Safe Harbor (Effective July 12, 2006)—Amends KRS 141.042 and KRS 141.990 to provide that businesses with a prior year tax liability of \$25,000 or less will not be subject to underestimation penalties if their corporation income tax declaration payments equal or exceed the prior year's liability. **(HB 403)**

Includible Corporations (Effective retroactively for taxable years beginning on or after Jan. 1, 2006)—Amends KRS 141.200(9)(d) to allow S corporations to be includible corporations filing a nexus consolidated return. **(HB 403)**

Intangible Expense (Effective retroactively for taxable years beginning on or after Jan. 1, 2005)—Corrects a drafting error that omitted the term *intangible expense* from KRS 141.205(2), which is the statute that grants authority to disallow deductions taken for payments made to related parties for the expenses related to the acquisition, use, maintenance, management, ownership, sale, exchange or other disposition of intangible property. The term *intangible expense* is already defined in KRS 141.205. **(HB 403)**

Related Member (Effective retroactively for taxable years beginning on or after Jan. 1, 2005)—Changes the confusing term *related members of an affiliated group* to *related member* in KRS 141.205. *Related member* is a defined term in KRS 141.205 and *related members of an affiliated group* is not defined. Confusion has occurred when reading the term *related members of an affiliated group* because the term *affiliated group* is also defined separately in KRS 141.205 and that definition is in conflict with the definition of *related member*. **(HB 403)**

Pass-Through Corporation Income Tax Credits (Effective retroactively for taxable years beginning on or after Jan. 1, 2006)—Amends KRS 141.420 to clarify that the nonrefundable and refundable pass-through corporation income tax credits do pass through to individual owners of multitiered ownership structures. **(HB 403)**

Denial of Pass-Through Credit (Effective retroactively for taxable years beginning on or after Jan. 1, 2006)—Amends KRS 141.420 to clarify that the nonrefundable and refundable pass-through corporation income tax credits are denied to the

individual if the corporation fails to pay the corporation income tax liability due. **(HB 403)**

Repeal of NOL Incurred in First Year of Operations (Effective retroactively for taxable years beginning on or after Jan. 1, 2006)—Repeals KRS 141.012, which provides corporation income taxpayers the option of carrying forward the net operating loss incurred for its first year of operations in Kentucky. KRS 141.011 was amended by HB 272 to require all net operating losses to be carried forward, making KRS 141.012 unnecessary. **(HB 403)**

Corporation Income Tax Returns for Disregarded Entities (Effective retroactively for taxable years beginning on or after Jan. 1, 2006)—Amends KRS 141.200(10) to clarify that a disregarded single member limited liability company shall be included in the corporation income tax return of its single member. **(HB 403)**

HEALTH CARE PROVIDER TAX

Health Care Provider Tax (Effective April 25, 2006)—Designates amounts received for the health care provider tax from hospitals in excess of \$180 million to be transferred into a special fund. Further stipulates the method by which hospitals are to be taxed in FY06-07 and FY07-08. Taxes for these years will be based on FY05-06 payments. **(HB 380)**

LEGAL PROCESS FEES

Legal Process Fees (Effective Jan. 1, 2007)—Increases fees for legal process by \$1 each and designates these increases for the Department for Library and Archives. **(HB 537)**

MOTOR FUELS TAXES

Mandatory E-Filing of Fuel Tax Returns and E-Payment of Tax Due (Effective on or after Jan. 1, 2007)—Amends KRS 138.240 to require the electronic filing of gasoline and special fuel tax returns and amends KRS 138.280 to require the electronic payment of the associated tax. The measure also requires the electronic filing of the petroleum storage tank environmental

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assurance fee return and provides an alternate method of filing or payment when electronic capability is not available under prescribed conditions. The Executive Budget provided \$2.5 million to implement these provisions. **(HB 556)**

Average Wholesale Price Adjusted (Effective April 25, 2006)—KRS 138.210(10) was amended to raise the base *average wholesale price* (AWP) to the ceiling AWP for the current FY05-06.

Rate Distribution Adjustment (Effective July 1, 2006)—The amendment to KRS 138.220(3) increased from \$0.01 to \$0.021 the portion of funds that are earmarked strictly for the Transportation Cabinet's use. The \$0.01 captured was from the rate increase effective July 2004 and was made permanent in 2005. Another \$0.011 rate increase was effective July 2005 and is made permanent in this bill. **(HB 380)**

MOTOR VEHICLE TIRE FEE

Motor Vehicle Tire Fee (Effective July 12, 2006)—Extends the motor vehicle tire fee an additional four years to July 31, 2010. **(HB 145)**

MOTOR VEHICLE USAGE TAX

Valuation Floor (Effective Jan. 1, 2007)—This provision addresses the issue of questionable or fraudulent affidavits of total consideration given for motor vehicles at the time of payment of motor vehicle usage tax. The measure establishes a valuation floor by providing that the value of a used motor vehicle for motor vehicle usage tax purposes be based upon the affidavit of total consideration given, unless that value is less than 50 percent of its trade-in value as listed in the automotive price reference manuals prescribed by administrative regulation. Excluded from the 50 percent of trade-in value floor are: new vehicles; vehicles with branded titles, such as salvage vehicles, rebuilt vehicles, and water and hail damaged vehicles; and vehicles not listed in prescribed reference manuals. The measure provides for a refund of any overpayment, plus interest, if the vehicle owner documents to the satisfaction of the department that based upon condition, the vehicle merited a *retail price* of less than 50 percent of trade-in value. **(HB 380)**

Trade-in Credit Authorization (Effective July 12, 2006)—Amends KRS 138.450 to re-insert language to allow trade-in credit when the prescribed reference manual is used to value a used vehicle for motor vehicle usage tax. This language was inadvertently deleted in 1998. By policy, interpreting legislative intent, the DOR has allowed such a trade-in credit. **(HB 557)**

Ownership of Vehicle Traded in (Effective July 12, 2006)—Clarifies that the owner of a used motor vehicle seeking trade-in credit may only receive such credit for trading in a vehicle that is registered to him. **(HB 557)**

Trade-in Credit for Out-of-State Purchases (Effective July 12, 2006)—Deletes language stricken by Jefferson Circuit Court in the *McGaren vs. Revenue Cabinet* decision, which ruled that language limiting trade-in credit to used vehicles purchased in Kentucky was unconstitutional. The decision effectively expanded the trade-in credit to used vehicles presented for registration regardless of where purchased. **(HB 557)**

Clarifying Language (Effective retroactively to July 1, 2005)—Amends KRS 138.450-138.470 to make conforming changes to mesh with motor vehicle usage tax provisions of HB 267 from the 2005 session and clarifies that taxpayer exemptions apply as prior to enactment of HB 267. **(HB 403)**

County Clerk Weekly Report (Effective July 12, 2006)—Reinserts language to establish the due date of the county clerk's weekly report of motor vehicle usage tax receipts, inadvertently deleted in 1982 when KRS 138.464 was amended. **(HB 557)**

PROPERTY TAX

Taxation of Commercial Watercraft (Effective Jan. 1, 2008)—Provides for equitable and consistent taxation of commercial watercraft and simplifies and streamlines the billing, collection and distribution of local property taxes on commercial watercraft. Currently, watercraft is taxed using one of three methods: (1) public service corporations under KRS 136.120; (2) nonresident watercraft taxed under KRS 136.181; and (3) resident tangible property taxpayer under KRS Chapter 132. This bill consolidates these companies under one method of taxation and changes the apportionment method to route

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miles. The measure establishes a 10-year provision for a disbursement from the general fund to hold harmless the counties that lose tax revenues compared with the 2007 calendar year because of the change in the apportionment method. **(HB 562)**

Omnibus Assistance to Veterans and Military Families (Effective April 25, 2006)—Inserts a property tax provision to waive penalties, interest or lien filing fees for delinquent ad valorem taxes for motor vehicles and have resulting liens released at no charge. No penalty, interest or fee will be charged if the vehicle's registration expired during the individual's service to the U.S. military and assignment to a military base or other location outside the U.S. and if the vehicle was stored on a military base and has not been operated on public highways during that time. **(HB 380)**

Apportioned Vehicles (Effective Jan. 1, 2007)—Provides for a property tax fee on apportioned vehicles to be collected under the International Registration Plan (IRP) in lieu of regular property tax. The tax will be calculated based upon miles driven in Kentucky compared to total miles and will be collected in the state or Canadian province in which the vehicle is registered and then remitted to Kentucky. The fee will be administered by the Transportation Cabinet. The provision also exempts semi-trailers used in interstate commerce from property tax. **(HB 380)**

Advertising of Delinquent Property Tax Bills (Effective July 12, 2006)—Changes the advertising requirements for delinquent real property tax bills to allow the delinquencies to be advertised in the newspaper for one week instead of the current three consecutive weeks. A provision is added to require that the week before the bills are advertised, a one-half page *notice of advertisement* must be published. This notice must include the fact that a list of uncollectable delinquent taxes is also available for public inspection during normal business hours at the business address of the city or county and on a city or county sanctioned Web site. The delinquent taxes must be posted on the Internet for at least 30 days with updates posted weekly. In addition, when the fiscal court publishes a list of delinquent personal property tax bills, the fee that may be added to

the amount due is increased from \$3 to \$5 per bill advertised. **(HB 171)**

SALES AND USE TAX

Out-of-State Recreational Vehicle, Boat, Trailer and Other Applicable Tangible Property Purchases (Effective Jan. 1, 2007)—Streamlines and simplifies the collection of applicable use tax by county clerks on tangible personal property purchased from out of state retailers when that property is first offered for titling or registration in Kentucky. Focuses on the targeted area of tangible personal property purchased out of state subject to Kentucky use tax. **(HB 380)**

In-State Vehicle Purchases (Effective Aug. 1, 2006)—Amends KRS 139.470 to require collection of sales and use tax on motor vehicles purchased from Kentucky retailers if the resident state of the purchaser would impose a similar tax on Kentucky residents purchasing motor vehicles in that state. The bill also provides that monies collected under this provision be designated to the Road Fund. **(HB 380)**

Tax Increment Financing (Effective April 25, 2006)—Expands the definition of *project* as that term is defined in KRS 58.010 to include any *public project* undertaken by a nonprofit corporation located within a county containing a consolidated local government or a city of the first class. **(HB 380)**

Exemption for Commercial Printers or Mailers (Effective July 12, 2006)—Makes permanent language previously included in the Executive Branch budget bill exempting commercial printers or mailers engaged in business in Kentucky from collecting sales and use tax on sales of printing or direct mail advertising materials that are both printed out of state and delivered out of state to the U.S. Postal Service for mass mailing to third-party Kentucky residents who are not purchasers of the advertising materials. **(HB 557)**

Vendor Compensation (Effective for tax periods after June 30, 2006)—The compensation a taxpayer may receive for collecting and remitting sales and use tax is limited to \$1,500 per month. **(HB 380)**

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TELECOMMUNICATIONS TAX

Interstate Communications Services (Effective Jan. 1, 2006)—Adds clarification about the tax base for the gross revenues tax on communications services to verify that interstate communications services are in the base and provides guidance on how these services are sourced to Kentucky. The language harmonizes wording on the imposition of the excise and gross revenues taxes. **(HB 403)**

Hold Harmless Distributions (Effective Dec. 1, 2005)—Places in statute the procedure to calculate the portion of the hold harmless distributions designated for political subdivisions, sheriff departments, school districts and special districts that is based on property taxes generated from telecommunications companies that were taxed as public service companies prior to the enactment of HB 272 in 2005. This language reflects the administrative practice previously adopted by the department to implement this legislation. **(HB 403)**

TOBACCO TAXES

Dry Snuff (Effective June 1, 2006)—Provides language to make a distinction between moist snuff and dry snuff. Dry snuff will be taxed at 7.5 percent as *other tobacco product* (OTP). Moist snuff will remain in the snuff category and be taxed at \$0.095 per unit. The original language inadvertently omitted this tobacco product from taxation as snuff or OTP. **(HB 403)**

Roll Your Own (RYO) Tobacco (Effective April 25, 2006)—Reconciles the language of the Master

Settlement Agreement (MSA) and other tobacco product OTP legislation enacted under the original provisions of HB 272 in 2005 to clarify that the OTP tax is an excise tax subject to escrow payments under MSA, which classifies RYO as a cigarette. RYO will continue to be taxed as OTP at the wholesale rate of 7.5 percent of gross receipts. RYO is removed from the KRS 131.600 stamping reference because RYO does not meet the definition of *cigarette* in KRS Chapter 138. **(HB 380)**

Cigarette Paper Excise Tax (Effective June 1, 2006)—A new wholesale cigarette paper excise tax on paper or a similar material suitable for use by consumers to wrap or roll tobacco into the form of a cigarette is created. The tax will be paid only once, regardless of the number of times the cigarette paper may be sold in Kentucky. The tax will be \$0.25 per package of 32 sheets. For packages of greater or less than 32 sheets, the tax will be calculated at \$0.0078 per sheet. **(HB 380)**

UTILITY GROSS RECEIPTS LICENSE TAX

Payment of Interest (Effective Jan. 1, 2006)—Makes changes to the utility gross receipts license tax administered by the DOR necessary to authorize the payment of interest and clarify how interest will be paid. **(HB 403)**

Allocation of Tax Receipts (Effective Jan. 1, 2006)—Codifies existing practices of several county and independent school districts to provide guidelines on how these districts may continue to have tax receipts allocated by average daily attendance if they so choose. **(HB 403)**

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Kentucky Tax Alert comments and suggestions should be addressed to the Office of Public Information, Finance Secretary's Office, Frankfort, Kentucky, (502) 564-9165, ext. 4500.

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